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EX PARTE

January 31, 1995

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street NW - Room 222
Washington, D.C. 20554

RE: Ex Parte filing
CC Docket No. 94-1

Dear Mr. Caton:

As requested by the Common Carrier Bureau in a Public Notice, DA 95-102, dated January 24, 1995, BellSouth hereby files ex parte comments on the document entitled "A USTA Proposal for the LEC Price Cap Plan."

If you have any questions regarding this matter, please do not hesitate to call the undersigned.

Respectfully submitted,

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Executive Director
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Attachment

cc: Karen Brinkman
Pete Belvin
James Coltharp
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	

COMMENTS ON USTA PROPOSAL

BellSouth Telecommunications, Inc. ("BellSouth") hereby comments on the *ex parte* presentation made by the United States Telephone Association ("USTA") on January 18, 1995, in response to a Public Notice issued by the Common Carrier Bureau, DA 95-102 (January 14, 1995).

I. The USTA proposal.

USTA proposes that the Commission adopt an optional local exchange carrier ("LEC") price cap plan that eliminates the sharing and lower formula adjustment mechanisms as part of a proposal to enhance consumer benefits in four areas: a) the fixed productivity offset of the current LEC price cap plan would be replaced by a moving average productivity offset; b) the "consumer productivity dividend" would be increased initially and then phased down over a three year period; c) there would be a one time, one percent reduction in the price cap index of each carrier, and d) the category of costs granted "exogenous" treatment would be substantially narrowed. BellSouth discusses each of these proposed modifications to the LEC price cap plan below.

II. Eliminate both sharing and the lower formula adjustment mechanisms.

As BellSouth and others demonstrated in their Comments in this proceeding, the Commission should eliminate earnings sharing and the lower adjustment mechanism because these devices retain the perverse economic incentives inherent in cost of service regulation.[1] The cost of service overlays in the current LEC price cap plan cause extreme damage to the efficiency incentives that price cap regulation was designed to promote. According to Strategic Policy Research, the current LEC price cap plan provides only about 18 percent of the efficiency incentives present in unregulated, competitive markets.[2]

In addition to the dampened incentives to improve operational efficiency, the hybrid LEC price cap plan does not provide LECs with the maximum incentive to invest in the telecommunications infrastructure. In evaluating when and how to invest, LECs are motivated--and indeed obligated to their shareholders--to pursue those investments that will reap the highest expected return consistent with the associated risk. The constraints on LEC earnings caused by

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[1]BellSouth Comments at 49-52 (May 9, 1994); BellSouth Reply Comments at 24-26 (June 29, 1994). See also, USTA Comments at 45-52, Harris Report at 21, Darby Report at 20 (May 9, 1994).

[2]BellSouth Comments at 18 (citing SPR Vision Paper at 22) (May 9, 1994); BellSouth Reply Comments at 8 (June 29, 1994).

the sharing mechanism result in far less incentive for LECs to reinvest in price cap services relative to other, less regulated lines of business that offer the potential for greater returns. Thus, the sharing and lower adjustment mechanisms should be retained only upon a convincing showing that they are essential to ensure that rates remain just and reasonable.

However, those parties advocating the retention of these vestiges of cost of service regulation have not even attempted to make such a showing. Indeed, these parties merely recite the mantra that sharing is "an essential safeguard" and an "integral component" of the LEC price cap plan with neither analytical support nor precedent for these assertions.[3]

The idea that earnings sharing is "an essential safeguard" in a price regulation plan is belied by the fact that neither the AT&T nor the cable price cap plans contain sharing mechanisms. Both of these plans were adopted pursuant to statutory requirements that rates be just and reasonable, the same standard against which the LEC price cap plan must be measured. Thus, Ad Hoc is clearly incorrect when it asserts that earnings sharing is a prerequisite to a lawful price cap plan.

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[3] Ad Hoc Comments at 24 (May 9, 1994); AT&T Comments at 29-30 (May 9, 1994); MCI Comments at 31-32 (May 9, 1994).

Some parties argue that earnings sharing should be retained until certain competitive thresholds are reached in the local exchange market. These parties ignore the fact that price regulation does not depend on the existence of a competitive marketplace, but rather provides a transition between cost of service regulation and a streamlined regulatory approach that is consistent with a competitive marketplace.

The Commission determined from the outset of its analysis of incentive regulation that price cap regulation is a more effective form of regulation than cost of service regulation during the transition from a monopoly to a competitive market. More than five years ago, the Commission held:

> [I]ncentive regulation represents a more effective method of policing shifting industry boundaries than rate of return regulation. The restraints on price increases become less significant when competition develops because competitive forces hold prices down.[4]

Later in the same Order, the Commission held:

> The incentive structure we propose to create does not depend upon the existence of competition.[5]

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[4]In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Report and Order and Second Further Notice of Proposed Rulemaking, FCC No. 89-91, released April 17, 1989 ("AT&T Price Cap Order") at para. 37.

[5]Id. at para. 575. The Commission also stated: "However, while we believe that the presence of competition adds to the reasonableness of the particular form of no-suspension zone we adopt for AT&T, we do not rely upon it as a necessary predicate." Id. at para. 892.

It is also clear from the Commission's Orders that the sharing mechanism was adopted primarily because of the Commission's uncertainty regarding the proper productivity offset, rather than because of the state of competition in the LEC access markets.[6] Thus, the Commission stated:

> Our second response to concern about the validity of applying a single productivity offset to a number of LECs is the adoption of sharing and adjustment devices.[7]

Likewise, the Commission justified the lower formula adjustment as a protection against an improperly specified productivity offset:

> We retain a lower end adjustment mechanism with modifications, in order to ensure that the plan automatically corrects itself should our selection of a productivity factor for the industry turn out to be too high for a given company.[8]

Parties seeking to tie the elimination of sharing to a showing that LEC access markets are competitive miss the

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[6]While justifying the adoption of earnings sharing as a safeguard against a possible misspecification in the productivity offset, the Commission did note that earnings sharing also provided an "added assurance" that LEC rates would remain within the zone of reasonableness "that competition more indirectly provides in the context of the interexchange market." In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, <u>Second Report and Order</u>, FCC No. 90-314, released October 4, 1990 ("<u>LEC Price Cap Order</u>") at para. 405, fn. 583. However, the Commission nowhere conditioned its view of the legality of either the AT&T or the LEC price cap plan on the existence of any given level of competition in the markets served by these carriers.

[7]<u>LEC Price Cap Order</u> at para. 7.

[8]<u>LEC Price Cap Order</u>, at para. 10.

point of price cap regulation. Price cap regulation should be imposed only in markets that are not yet effectively competitive. Once a market becomes effectively competitive, either streamlined regulation or no regulation at all is appropriate.

Now that the Commission has gained four years experience with LEC price regulation, it should be apparent that the cost of service overlay is no longer needed, and should be eliminated from the LEC price cap plan. In its Comments, BellSouth identified numerous issues pending before the Commission in other proceedings that could be rendered moot or greatly simplified if earnings sharing is eliminated from the LEC price cap plan.[9] Thus, sharing should be eliminated regardless of whether the Commission makes other adjustments in the LEC price cap plan.

If, however, the Commission determines that it must obtain additional consumer benefits to justify the elimination of sharing, it could adopt an optional overlay on the existing price cap plan, as now proposed by USTA. Such a plan significantly increases the risk to the participating LECs. For example, a LEC electing to participate in the optional USTA plan will have to determine that it is willing to bear the risk that the productivity offset may be misspecified as to that carrier. If a carrier is not willing to assume that risk, it can remain under a

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[9]BellSouth Comments at 71-74 (May 9, 1994).

price cap plan that retains the sharing and lower adjustment mechanisms.

The USTA proposal also ties the elimination of sharing to the provision of additional consumer benefits by the price cap LEC. Each of the new elements of the USTA proposal provide additional consumer benefits, and correspondingly increase the risk to the electing LEC. As discussed below, some of these elements of the USTA plan go beyond what the Commission could legally order in a mandatory price regulation plan, in BellSouth's view. By making the overlay optional, the Commission can avoid some of the legal pitfalls that might otherwise torpedo its efforts.

III. The moving average productivity offset.

USTA's proposal for a self-adjusting productivity offset that reflects a five year moving average of growth in industry total factor productivity should be adopted as part of an optional price cap plan. This mechanism ensures that consumers receive the benefit of the actual productivity improvement achieved by the LECs, while eliminating the need for frequent price cap productivity performance reviews. The use of a rolling average flattens out the wide variations in year-to-year and company-to-company measurements of total factor productivity. By flowing through to consumers the actual level of productivity improvement achieved by the LEC industry, the need for a sharing mechanism is eliminated.

IV. The "Consumer Productivity Dividend".

The adoption of the USTA self-adjusting productivity offset will mean that the full effect of the achieved improvement in total factor productivity ultimately will be passed along to consumers in the form of lower access prices. Thus, a Consumer Productivity Dividend ("CPD") is not viable as a permanent feature of the optional price regulation plan. However, there may be a short window of opportunity during the transition to the self-adjusting productivity offset mechanism for the Commission to capture some additional benefit for ratepayers. Therefore, the Commission should adopt a three year CPD that begins at 1.0 percent in the first year and phases down to 0.5 percent in the second year and 0.25 percent in the third year. After three years, the CPD would be eliminated. This feature would provide additional up front consumer benefits, while properly specifying the long term productivity goal through the moving average productivity offset.

V. One time reduction in the price cap index.

Despite the Commission's request for comment on the issue of a one time adjustment in the price cap index, and its support by non-LEC parties, neither the Commission nor any other advocate of a one time index adjustment has come up with a supporting rationale that withstands legal scrutiny. A mandatory index reduction could be ordered only pursuant to the Commission's authority to prescribe just and reasonable rates. 47 U.S.C. § 205. However, the Commission has made no examination of the reasonableness of LEC rates in this proceeding. The Commission has expressly held that aggregate rates that comply with the price cap formula are presumed lawful and are not subject to challenge on the ground that they produced unreasonably high earnings.[10] Thus, there is no legal foundation upon which the Commission could mandate a one time reduction in the price cap index of any LEC.

The Commission obtained an up front rate cut in 1990 by represcribing the rate of return used to initialize the LEC price cap plan. However, after the price cap plan was initialized, price cap LECs are no longer subject to a prescribed rate of return, and the Commission has not undertaken a proceeding to represcribe the rate of return. Therefore, the Commission cannot lawfully order a one time index adjustment or rate cut.

Although the Commission cannot lawfully <u>require</u> a one time index (or price) reduction by the price cap carriers in the current proceeding, the Commission could include such a reduction in an <u>optional</u> package tied to the elimination of sharing. Because each carrier would make its own decision whether to elect the optional plan, inclusion of a one time

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[10] <u>LEC Price Cap Order</u> at para. 406.

index reduction in an optional overlay would have a much better chance of surviving judicial scrutiny.

VI. Exogenous cost adjustments.

USTA has proposed reducing the scope of the "exogenous" cost adjustment to two categories: government mandated changes that uniquely affect telecommunications companies, and changes in long term support mechanisms (i.e., universal service funding). Agreeing to this limited scope for "exogenous" costs would increase the risk to the LECs. LECs would, for example, have to absorb the impact of future changes in Generally Accepted Accounting Principles ("GAAP").

Narrowing the scope of "exogenous" costs clearly increases the risk to the LEC of non-recovery of these costs. It is hard to see how the Commission could require that the scope of "exogenous" costs be narrowed, since the Commission found in the LEC Price Cap Order that the present list was necessary to prevent rates from becoming too high or too low, and the Commission did not narrow the scope of "exogenous" costs for AT&T during its price cap review. The Commission also adopted an expansive view of "exogenous" costs in the cable regulation proceeding. Thus, the only way that the Commission may be able to narrow the scope of exogenous costs and withstand judicial scrutiny is as an element of an optional price cap plan, such as that suggested by USTA.

VII. Conclusion.

The optional price regulation plan presented by USTA in its *ex parte* filing would substantially increase the financial risk to any LEC that elected to be regulated under the plan. It is therefore appropriate that such carriers obtain the potential reward that could flow from the elimination of the sharing and the lower formula adjustment mechanisms. BellSouth therefore supports the USTA proposal.

Respectfully submitted,

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January 31, 1995